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SENSITIVE

DEPARTMENT FOR SA/INS
DEPARTMENT PASS TO USTR - JROSENBAUM AND AWILLS
COMMERCE FOR ARI BENAISSA; MCC FOR DNUMMY

E.O. 12958: N/A
TAGS: ECON ETRD EAID CE USTR ECONOMICS
SUBJECT: Sri Lanka Exceeds 2003 GDP Expectations; Serious Questions Confront New GSL in Economic Arena

Sensitive but Unclassified. Please handle accordingly.

¶1. (SBU) Summary: The Sri Lankan economy responded remarkably well to continued peace and economic reforms in 2003, and stymied naysayers who thought political instability during the final quarter would hurt overall growth. GDP grew by 5.9%. Per capita GDP rose to $947. There were commendable achievements in monetary policy management, fiscal (expenditure) control, and the trade sector. Prospects for 2004 are uncertain due to conflicting economic rhetoric and welfare promises of the newly elected coalition government, which includes a leftist coalition partner. If peace holds, however, and the international economy continues to expand (spurring export growth), economic growth in the 4-5% range is still possible. However, long-term damage due to economic reform reversals could be substantial. End Summary.

¶2. (U) The Sri Lankan economy performed well in 2003, largely the result of the continuing peace process between the GSL and the Liberation Tigers of Tamil Eelam (LTTE) terrorist group. There had been considerable concern that economic growth would fall to less than 5.5%, due to political uncertainty that began during the last quarter of the Sri Lankan fiscal year.

¶3. (U) According to the Central Bank of Sri Lanka, the GDP expanded by 5.9% (compared to 4% in 2002 and -1.4% in 2001), to $17.6 billion. The higher growth is mostly attributed to peace and economic reforms begun in 2002. It also indicates the strengthening of the private sector and strong export growth. Significantly, per capita GDP (in this nation of 19.3 million people), rose by 8% to $947. The peaceful atmosphere in the country led to gains across all major sectors of the economy. Services, industry and agriculture grew by 7.7%, 5.5% and 1.5%, respectively. Services sector is the largest economic sector contributing to 55% of GDP. Industry and agriculture contribute 26% and 19% of GDP, respectively.

¶4. (U) Tourism rebounded strongly in 2003, with tourist arrivals reaching the 500,000 mark for the first time. Telecommunications, transshipment through Colombo port, and banking activities all grew quite strongly. In addition, property markets, not only in the capital but elsewhere, especially down the southern coastline, picked up. According to the Central Bank, employment has increased during 2002-2003. Agriculture, construction, transport and communications sectors saw high job growth in 2003.

¶5. (U) Most other economic indicators also showed improvements in 2003. The budget deficit was held to 8.0% of GDP, compared with 8.9% in 2002 and 10.9% in 2001, through expenditure control. Significantly, defense expenditures declined to 2.7% of GDP in 2003 from 3.1% in ¶2002. In nominal terms, the actual defense bill was Rs 47 billion ($480 million) in 2003, compared with an estimated requirement of more than Rs 100 billion ($1 billion) in the absence of peace. Public investment increased to 5% of GDP from 4.6%, but was below the planned target of 5.3%.

¶6. (SBU) The achievements on the deficit front were in line with the new Fiscal Management Responsibility law, which aims to bring the deficit to 5% of GDP by 2006. Despite these achievements, falling government revenue remains a major problem. Revenue fell to 15.7% of GDP in 2003 from 16.5% in 2002. Tax revenue dropped to 13.2% of GDP, much below the target of 15%. The fall in government revenue was a major factor in the IMF's decision to hold back the first review under the PRGF. Domestic financing of the government deficit declined substantially from 8% of GDP to 4.5% of GDP. Privatization proceeds amounted to $105 million (0.6% of GDP).

¶7. (U) Due to lower domestic financing of the deficit, there were substantial gains in monetary management with Treasury bill interest rates falling to about 7.5% from 10% in 2002. Similarly, the prime-lending rate was reduced to 9.3% compared with 12% in 2002. The gains in the monetary

front are much steeper when compared with the high rates of 18%-21% in 2000. Inflation was brought down to 6.3% in 2003 from over 10% in 2002-2001. The Sri Lankan rupee, which has been continuously depreciating in the past several years, held steady despite political squabbles. Investment (22.3%) and domestic savings (15.7%) are still below desired levels. Foreign investor flows were also quite meager with FDI at $181 million.

¶8. (U) External sector performance was commendable. Exports increased by 9.2% to $5.1 billion in 2003, after declining in the previous two years. Garments account for 50% of total exports, with the US as the main buyer (61% of total exports). Tea is second with 13% of total exports. The trade deficit expanded in 2003 to $1.5 billion, but private remittances from Sri Lankans abroad ($1.4 billion), services, FDI, and development assistance helped to restrict the current account deficit to 0.6% of GDP and post an overall Balance of Payments surplus (for the third consecutive year) of $502 million. Consequently, external reserves increased to $3.2 billion providing 5.8 months of import cover. The debt service ratio also declined.

¶9. (U) The Colombo Stock Exchange (CSE) performed very well in 2003 reaching its peak in October 2003. This performance earned it the position of the world's second best performing stock market (Fortune). Since then, business confidence has taken a beating -- despite a rise in corporate earnings -- due to political squabbles and the protectionist rhetoric of the new government. Exchange indices remain 14% below their peak.

¶10. (SBU) Comment: The economic outlook is mixed. 2003 was a better year than expected, but 2004 has been wracked with political uncertainty and continuing drought. On the positive side, though certain segments of the current government coalition have espoused a shift to a "mixed economy" (during its campaign and since coming into power), from the largely free market economic policies of the previous government, some key UPFA leaders, including the Finance Minister, changed their stance once in office. Privately many officials have assured us that they intend to continue with the previous government's policies, albeit with some changes, including a greater focus on the rural economy. This is understandable given the rural backlash during the election against the former government, as a result of a perceived lack of attention to the rural sector and poverty alleviation.

¶11. (SBU) Nonetheless, continued delay in the announcement of the Government's economic plan, news of potential fuel and fertilizer subsidies, conflicting statements on privatization, increased state employment and a fairly chaotic transition in the Finance Ministry have all fueled business sector worries. (Note: the long-standing Deputy Secretary of Finance, widely seen as the key player on

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Finance matters resigned following an announcement that he would be "reassigned." Headlines have also trumpeted a reported feud between the Finance Minister and Secretary (who is close to the President) on the direction of economic policy. End note.) The Central Bank has already revised its growth forecast for 2004 from 6% to 5%, citing the effect of political disputes and the continuing drought.

¶12. (SBU) If peace continues, even in the absence of deep economic reforms, key sectors of the economy such as tourism, private remittances, and exports should hold steady at least in the short term (some export opportunities may be lost with the expiration of the Multi-Fiber Agreement in January 2005). These sectors would also benefit from continued recovery in the international economy. One or more negative developments such as a setback in the peace process, indications that electoral Marxist rhetoric was becoming a reality, continued political transition uncertainties, slow infrastructure investment, or increased unproductive state employment could hold back private investment, FDI inflows and economic growth. There are teams from IMF and ADB in town this week and the Millennium Challenge Corporation team arrives next week. Readouts from these visits should be interesting and a good gauge of whether or not the GSL has answers to the mounting economic questions it faces. Whether the new GSL is ready or not, though, it's clearly showtime. End comment.

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